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FISCAL REFORM AND STRUCTURAL CHANGE:

MACROECONOMIC, POLITICAL ECONOMY, AND THEMATIC ISSUES

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I. Introduction

There are a great variety of tax systems to be found in the different countries of the world, even among countries at similar levels of income. While at first glance this observation suggests that many or most systems are not very efficient or rational - in the sense of being based on economic theory - this is often not the case. Tax systems can be different for a variety of reasons, bad policy being just one of them. Historical factors or initial conditions, institutional matters, economic structure, the macroeconomic background, political economy considerations, as well as different social welfare functions also matter. Therefore, any assessment of a tax system for a particular country which does not take all these elements into account is likely to be widely off the mark. On the other hand, there does seem to be a tendency for tax systems in developing countries to converge in recent years. Does this mean that countries are becoming more similar? Or that there is a new-found economic wisdom based on efficiency considerations which are common to countries with very different economic structures, institutions, and initial conditions? Or that similar challenges, such as the one posed by a greater integration into world markets, particularly at the financial level, are driving the tax reforms and thus leading to similar policy answers? Or perhaps this convergence is only a temporary one as developing countries around the world recover from the large shocks and fiscal deficits of the 1980s?

Through a series of country studies and broader thematic chapters, a major goal of this project has been to shed light on some of these questions. In this synthesis chapter we will try to bring attention to some of the key issues developed in the various chapters, with the hope that a careful examination of the evolution of fiscal systems in a number of countries will result in a clearer understanding of the trends that we are perceiving in developing economies in the 1990s. As Hutton and Whalley have already covered the quantitative modelling chapters in their synthesis, we will be focusing almost entirely on the qualitative and thematic chapters.[1]

We begin in Section II with an examination of the role that macroeconomic considerations have played in fiscal reform. In particular, the role of fiscal deficits in macroeconomic instability and the reverse causality are discussed. Fiscal reform has also often been an integral part of structural adjustment. Section III of this summary examines the interaction of structural reform and fiscal reform, with an emphasis on the roles of trade reform and tax incentives in the adjustment and growth process. In the fourth section we will go into more detail on two of the emerging issues, environmental and sustainable development taxation and fiscal federalism. These will be followed by a discussion of issues commonly referred to as political economy. In particular we will emphasize income distribution. Section VI will discuss the role that

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[1] Note that the quantitative and qualitative studies have been integrated in the cases of the Philippines and Cote d'Ivoire.

tax administration considerations have played in the recent trends and debate and examine their interface with economic structure. The last section contains some brief conclusions.

II. Macroeconomic Considerations

It is clear that many of the fiscal reforms undertaken in the 1980s, especially in Latin America, were driven by the desire to reduce or eliminate macroeconomic instability. There are currently no major disagreements among economists in that the causality between fiscal imbalances and macroeconomic disturbances basically runs both ways. However, most economists also agree that while the effects of macroeconomic variables on the behaviour of the public accounts probably tend to prevail in the short run, the impact of autonomous fiscal policies on macroeconomic performance certainly becomes the mores important linkage in the longer run. Consequently, there is a broad consensus that sustained stabilization is impossible without fiscal discipline.

Simultaneously, there is also a greater awareness that due to the difficulty of making large, rapid expenditure cuts (especially in the numerous countries which already made massive cuts in the 1980s), unstable tax systems will sooner or later put pressure on macroeconomic stability. That is, fiscal systems whose revenues fluctuate sharply will inevitably have inflationary repercussions. Of particular concern in this matter are tax systems which are greatly (or disproportionately) affected by external shocks. Accordingly, fiscal reform has been aimed at both rectifying unstable situations and diminishing the probability of future instability.

The importance of controlling the fiscal deficit in order to consolidate stability is particularly clear in the case studies of Argentina and Mexico. Several stabilization attempts in Argentina in the 1980s were failures largely due to the inability to control the fiscal deficit. Rozenwurcel argues that the fiscal problem became persistent after the government assumed much of the large increase in private debt generated by the huge rise in international interest rates. Numerous attempts to reduce inflation failed due to an inability to contain the fiscal deficit, despite large cuts in expenditure, primarily in the area of public investment. Even though the trade imbalance was diminished substantially and quite rapidly, the government faced an internal transfer problem in dealing with the external transfer. That is, it was not able to generate enough tax revenues to pay the interest on the external debt.

It is only in the most recent stabilization plan, the Convertibility Plan of 1991, that the fiscal deficit and inflation seem to have been controlled. However, Rozenwurcel argues that macroeconomic stability preceded the correction to the fiscal deficit. By using the nominal exchange rate as an anchor - the new Argentinean peso was made constitutionally convertible to the US dollar at a fixed rate - the immediate effect of the plan was to produce a sharp reduction in inflation, which fell from 1343.9 per cent in 1990 to 84.0 per cent the following year, and further to 17.5 per cent in 1992. The swift recovery in economic activity and the reverse Olivera-Tanzi effect led to an increase in tax revenues of about 2 per cent of GDP in 1991. Nevertheless, unlike the Austral Plan of 1985, when a similar result was obtained, the government took strong steps to reduce the deficit even further and to make this reduction sustainable. The substantial decrease in the level of public debt and the large amounts of cash obtained from the privatization of state owned enterprises have been of particular importance for the success of adjustment in the first four years.

Urzúa paints a similar picture in Mexico where an agreement on an incomes policy between the government, business sector and unions was able to bring inflation down quickly from 159.2 per cent in 1987 to 51.7 per cent in 1988, and further to 19.7 per cent in 1989. Once again there was an immediate payoff via the reverse Olivera-Tanzi effect. The government quickly built upon this dividend, reducing the fiscal deficit even further via a combination of tight monetary and fiscal policy. Similar to Argentina, privatization proceeds have played an important role.

All of the countries of the study have taken or attempted important steps to cope with the increasing integration of their economies into the world markets, at both the trade and financial levels. They have been forced to do so in order to reduce the vulnerability of their fiscal systems to external shocks, and at the same time prevent the emergence of excessive fiscal imbalances from rapidly deteriorating their external positions - particularly in the capital account. This is probably the most important common reason why they all have tried to place more reliance on a value added tax and, just as important, to broaden the base, reduce rates and their dispersion, and strengthen the compliance of both the VAT and income tax. One important result of all these measures should be that the fiscal balance is not disproportionately affected by the performance of a small number of sectors, especially those in which primary exports are concentrated. The cases of Colombia and Cote d'Ivoire are the most revealing in this respect, with the latter facing a major structural shock since the late 1970's and the former recurrently having to deal with price or quantity disturbances of a temporary nature.

The Cote d'Ivoire fiscal balance was put into a semi-permanent state of disrepair when the prices of its main exports - coffee and cocoa - began a long-term decline in the late 1970's. Not only were tax revenues very dependent on these two commodities both for direct and indirect (multiplier) reasons, the government also maintained a price support system for farmers, which ran large deficits from 1978 until its discontinuation in 1991 in all but two years.[1] To magnify the problem, Cote d'Ivoire is a member of the West African franc zone which makes devaluation extremely difficult.[2] As the countries of the franc zone have a common central bank, Cote d'Ivoire does not have control of its monetary policy. To close its fiscal gap, it has largely relied upon external borrowing. As a matter of fact, the inability to monetize the deficit has been one of the reasons why the country has avoided the inflation problem of many Latin American economies. The cost has been, however, the build-up of an enormous external debt. Enoh, Enoh and Koffi argue that in order to at least partially insulate the economy from external shocks the obvious solution is to put more reliance on the VAT and income taxes. However, the rates of these taxes are already at very high levels, and due to the informality of much of the economy it is difficult to broaden their narrow bases. In the end they argue that (in addition to a real devaluation) most of the effort will have to be put on better tax administration as fraud and evasion are both rampant.

Perry and Herrera contend that the Colombian fiscal balance follows commodity cycles, a situation which may become even more pressing due to the recent oil discoveries and the importance petroleum exports have gained in recent years. While tax reform in Colombia, which has occurred piecemeal over the last 20 years, has often been aimed at reducing the vulnerability of revenues to external shocks, they argue that this has not been enough. A more permanent solution would be to set up stabilization funds which would be used for revenue and expenditure smoothing as well as, in the case of coffee farmers, income smoothing. In fact, in the coffee price boom of 1994 a large part of the windfall has been invested abroad for this reason and in order to keep the exchange rate from appreciating. Moreover, in late 1994 a bill has gone before congress to set up an oil stabilization fund. This fund is intended to smooth public expenditure before what is perceived as a sharp but temporary increase in oil extraction, and therefore in public revenues, due to a discovery of a major new basin. Indeed, oil production is expected to reach its peak in five years and then decline. In addition, most of the money in the fund would be invested abroad to mitigate the effects of the boom on the real exchange rate.

The thematic chapter by McMahon and Schmidt-Hebbel (MSH) contains an extended analysis of the relationship between stabilization and fiscal reform. Their main argument is that countries which rely on concentrated or narrowly-based and/or unconventional taxes are very susceptible to instability. The two main unconventional taxes which they discuss are the inflation tax and financial repression tax. If its fiscal balance deteriorates due to an external or domestic shock, a country will find it difficult to increase revenues from either of these sources. Greater financial repression will likely have negative growth effects and, thus, further diminish conventional revenues. The inflation tax take can only be increased past a certain point via exponential increases in inflation. Of course, if the conventional tax base is heavily concentrated in a small number of narrowly defined taxes, there also may be little room to manoeuvre on this front. Moreover, as the Cote d'Ivoire case study demonstrates, when such taxes are affected by external shocks, the results can be disastrous.

Regarding the sequencing of reforms, MSH also argue that in cases of extreme macroeconomic instability it will often be necessary, as occurred in Argentina and

Mexico, to rely on short-run quick-fix tax measures. Eventually the initial policy setting will have to be substantially adjusted if stability is to be sustained. Moreover, particular attention must be paid to the effects of other reforms or policy changes on tax revenues; if they are likely to have strong negative repercussions on the fiscal deficit, they may have to be delayed until stabilization is secure. They place particular emphasis on the path of the real exchange rate. For example, countries which are facing both a large current account imbalance and a fiscal deficit may find that the real devaluation needed to rectify the former can play havoc in the short-run with the latter. This might happen whenever the net effect of a real devaluation on the fiscal stance is negative, as could be the case, for instance, if the net foreign debt of the government is large and the value of its interest payments in local currency rises significantly. As Rozenwurcel suggests for Argentina, other relevant cases in which important trade-offs between structural change and the fiscal balance can arise are the reform of the social security system or attempts to promote faster export growth via tax expenditures.

MSH also look at the question of two-way causality between macroeconomic instability and fiscal deficits. Using a number of econometric tests they conclude that cross-country evidence points to most of the causality running from the deficit to instability in the long-run. Nevertheless, they acknowledge that once instability becomes severe, the country will usually enter a vicious circle in which the instability causes the deficit to worsen which again increases the instability.

In sum, the results of this study strongly confirm the interaction of fiscal deficits with macroeconomic instability. The two most important lessons are: (i) Certain types of tax systems are more susceptible to macroeconomic instability than others. One of the most important motivations behind the recent trends in tax reform in developing countries has been to make the fiscal balance less susceptible to external and domestic shocks. Nevertheless, economies heavily dependent on export revenues of a small number of primary commodities may want to think in terms of internal stabilization funds and not only broadening the base of existing taxes. (ii) Countries with extreme instability are well-advised to deal with the fiscal problem any way possible in the short-run. However, such measures must be quickly adapted to a fiscal system able to sustain stability in the long-run.

III. Structural Adjustment and Growth

Fiscal systems - both taxes and subsidies - have often been used to promote development, albeit with mixed and controversial results. Import substitution policies were largely based on fiscal policies; that is, high tariffs to keep out imports and various subsidies and tax incentives to encourage the development of domestically based industry. Therefore, given the strong movement away from import substitution policies in the 1980s, it would be surprising if fiscal reform did not play an important part in structural adjustment programs. In the countries of our study (as in many other developing countries), this movement has mostly been towards a level playing field rather than export incentives. In all the countries of our study there have been massive decreases in tariffs (or movements from quantitative restrictions to tariffs), and in most countries there have been significant reductions in subsidies, tax incentives and export taxes. Similarly, many state owned enterprises have been privatized in Mexico, Argentina, and, more recently, Cote d'Ivoire. In a nutshell, with regards to growth the main aim of fiscal reform has been to encourage a movement back to comparative advantage. However, an unfortunate consequence of the enormity of the fiscal deficits that the countries had to tackle was that, except for Colombia, all of the countries in the case studies have had large cuts in public investment, both in new infrastructure and maintenance of old infrastructure.

Colombia is the most interesting case in our study of a country which has seemingly kept the long-term structural effects of its successive fiscal reforms in mind throughout the last fifteen years. Perry and Herrera argue in their chapter that most tax reforms in Colombia were geared to broader structural reform packages; quick-fix tax changes were rarely relied upon. Indeed, only when the fiscal deficit became serious in the mid-1980s did the government respond by temporarily increasing tariff rates. As a consequence of this long-term approach and, of course, its remarkable record of macroeconomic stability, Colombia developed a tax system similar to the consensus described in the introductory chapter much sooner than most developing countries. In fact, Colombia now seems poised to deal with the next steps in the evolution of its fiscal system - stabilization of revenues and expenditures and decentralization.

It was noted above that privatization has played an important role in the fiscal reform of some of the countries. In Mexico and Argentina the official explanation has been that privatization has primarily occurred for efficiency reasons. However, both Urzúa and Rozenwurcel in their Mexican and Argentinean studies, respectively, say that at least ex-post the driving force behind privatization was that the returns on the sales were badly needed to help cover both the short-run and (by retiring debt) long-run fiscal deficits. Rozenwurcel argues that it is still too early to say whether there have been any substantial systemic efficiency gains due to privatization in Argentina. The unfortunate creation of quasi-monopolies certainly seems to have reduced some of the expected benefits.

The main lesson coming out of the case studies is that many countries see fiscal stability as more important for growth than a system of tax incentives, protection and subsidies. In their thematic chapter McMahon and Schmidt-Hebbel (MSH) estimate that there is a significant negative correlation between GDP growth and the ration of the fiscal deficit to GDP. They also argue that when fiscal deficits lead to a heavy reliance on the financial repression tax, the resulting distortions in financial markets (usually very low or negative real interest rates and rationed credit) are likely to have a negative effect on growth. They also see Colombia as a good example of a country which has followed (and continues to follow) a sub-sequence of fiscal reforms in order to compensate for or harmonize with the other structural reforms. In fact, MSH argue that it is almost always likely to be the case that as a country goes through a lengthy adjustment process, the fiscal system will continually have to adapt to the other reforms. Moreover, the speed of the other reforms will also be conditioned by the adaptability of the fiscal system.

The crucial importance of fiscal stability for economic growth does not mean, however, that stability alone will automatically produce growth, but rather that it is one of its more basic necessary conditions. In fact, as the much debated performance of the East Asian economies seems to suggest, once fiscal stability is firmly grounded, other policies including tax incentives and subsidies might sometimes be useful in promoting growth. Along this line, the chapter by Kwack and Yoo discusses the myriad of tax incentives, exemptions and subsidies that South Korea and Taiwan, two of the greatest success stories of the last 30 years, have employed to stimulate industry.[3]

Though there is still no consensus on the issue, it seems that rather than to consider tax incentives and subsidies a Bad Thing in general, as the ruling fiscal orthodoxy assumes, a more constructive approach should discuss when they can play a positive role and how they can be designed, implemented and monitored so as to make them more efficient and effective. Bird examines the question in detail in his thematic chapter, focusing on investment incentives. He first argues that investment incentives are still very common in the world, despite their relative demise in Latin America. Given that they have existed for a long time and are likely to continue in one form or another for a much longer time, he then discusses the pros and cons of different incentive schemes and derives a number of conclusions. His main complaints are that it is very rare that any attempt is made to track the results of incentives and, moreover, that there have been very few attempts to evaluate their results. Accordingly, he argues for better record keeping systems as well as periodic and rigorous evaluations. In fact, he espouses sunset rules in which a set of incentives will disappear after a certain time unless their renewal can be justified. Regarding their design, he also argues that complex incentives rarely work. For example, narrow targeting which assumes the government can pick winners better than the private sector have rarely succeeded. Therefore, investment incentives should be broad-based - he favours full or partial expensing for machinery and equipment - and open to anyone who meets a simple number of criteria. Finally, he notes that very poor countries will have difficulty in administering or paying for investment incentives and the economies of rich countries are too complex. Therefore, their practical usefulness is probably limited to middle-income countries with stable macroeconomic environments.

Regarding the need to harmonize structural reforms in different areas of the economy, in their thematic chapter on the interface of trade and tax reform Devarajan and Panagariya stress that any reduction in tariffs should be assessed against alternative measures. On the other hand, they point out that in a study examining 40 cases of tariff reduction (including the removal of quantitative restrictions) in developing countries, 27 of the reforms actually resulted in an increase in tariff revenue. This is of course the outcome to be expected, particularly in the short run, when prior to the reform quantitative constraints are prevalent and there is a significant dispersion in tariffs, with the highest rates charged to the goods with the most stringent import quotas.[4] However, considering the relatively minor importance of tariff proceeds in the overall tax collection of industrialized countries, it is almost certain that, at least in the long run, higher domestic tax revenues will have to compensate for the fiscal losses resulting from trade liberalization.

In any case, the main argument of the chapter by Devarajan and Panagariya is that, in contrast to many theoretical results in developing countries, the move towards uniform tariffs cannot be considered efficient or optimal in the normal public finance sense. That is, due to the fact that many goods, services, and sources of income fall out of the tax net, the flattening and broadening of tariffs cannot be justified on economic efficiency arguments. However, it could be justified in terms of what Slemrod (1990) calls optimal tax systems, in contrast to optimal taxes, due to the high administrative costs associated with tax collection in developing countries. Very simple systems are both much easier to administer and give less incentives to lobby. Therefore, any loss in efficiency caused by the use of non-optimal taxes may be more than compensated by a reduction of the deadweight losses associated with tax collection and rent-seeking.

In sum, the results of the present study suggest that the greatest role that fiscal policy can play with regards to growth is to ensure macroeconomic stability. At the same time this implies that growth oriented structural reforms must pay special attention to their consequences for the fiscal balance. Although growth via the import substitution route has been largely discredited, trade liberalization must be undertaken with caution. To date privatization seems to have affected growth more by its role in reducing fiscal deficits than increasing efficiency. Finally, there does seem to be some scope for the use of investment incentives in a country whose house is in order, although they would do well to heed the various warnings advanced by Bird.

IV. Emerging Issues in Fiscal Reform

Perhaps the three issues which will see the greatest increase in attention in the next ten years are revenue and expenditure stabilization, fiscal federalism, and environmental and sustainable development taxes. The first of these has been discussed in the last two sections; in this section we will examine what the various studies in this volume have to say about the second and third.

Fiscal federalism is, of course, not a new issue. However, in most developing countries either little attention has been paid to the matter or it has only been addressed in an ad hoc manner with political power rather than economic analysis dictating its form. As the chapter by Boadway, Roberts, and Shah convincingly argues, the crux of the problem is that most revenues are best collected by the central government while most expenditures are best made by the state or provincial and local governments.

In our case studies Argentina and India are the only countries which historically have had a substantial amount of decentralization. However, in the last ten years Colombia has begun a significant movement towards decentralization, while there are great pressures in Mexico and Philippines to do likewise. Most developing countries have strong central governments and the countries in our sample are no exception. However, out of the various crises of the state in the 1980s came a realization (or belief) that a significant part of government inefficiency was the result of excessive centralization.

Developing countries which historically have been partially decentralized, such as Argentina, Brazil, and India, have generally faced three problems. The first is that it has usually been the case that sales taxes fall under provincial or state jurisdiction, which has resulted in cascading effects due to the difficulty of having something akin to a value added tax in a region without an official border. See Sarma's chapter on India for a description of the MODVAT or modified value added tax in India, which is an attempt to overcome part of this problem. The second is that central governments have usually found it extremely hard to control the excessive levels of indebtedness which regional authorities often incur. The third, and more crucial, is that the institutional arrangements have been inadequate. As Rozenwurcel shows, Argentina has been a classic example of a country in which attempts by the central government to address fiscal problems have been partially thwarted by provincial governments. In fact, this is still one of the most outstanding issues with regards to the sustainability of the Argentinean fiscal reform in the context of the Convertibility Plan. Perry and Herrera point out that fiscal federalism issues are likely to be near the top of the agenda in Colombia for the rest of this decade. This belief stems partly from the realization that the revenue side of the decentralization equation has not kept pace with the expenditure side and partly from the fear that fiscal discipline could be a problem in the future due to the automatic nature of most transfers. Similarly, Sarma sees the battle for control of sales and other taxes as being a central issue in Indian political economy for the next decade.

In their thematic chapter Boadway, and Shah (BRS) give a detailed analysis of the reasons for assigning different taxes and expenditures to the various levels of government. They argue that the main reason for concentrating expenditure at the federal level is for redistributive reasons. In developing countries where this aspect of the fiscal system has still been given much less importance than in industrialized countries (partly as income taxes are much less prominent), this suggests that most expenditure should be at lower levels of government. Nevertheless, with the exception of property taxes and, perhaps, retail sales taxes, there is a significant administrative cost to decentralization of revenue collection. If adequate institutional arrangements can be constructed, it is usually much better to have the federal government collect the bulk of tax revenue and then transfer it down. Of course, BRS also make it clear that this also signifies that there must exist very clear rules for accountability with respect to the expenditures. At the same time, an important and feasible policy objective should be to broaden the bases and to improve the compliance of the taxes remaining under provincial or local jurisdictions.

In theory, environmental and sustainable development taxation (or "green taxes") seems to offer the best of both worlds. The government collects revenues which rectify the fiscal balance problem by taxing negative externalities or "bads". Nevertheless, the move to green taxation has been very cautious to date and will likely continue to be so, although, as Pasco-Font argues in his thematic chapter, this is not primarily due to perceived growth reducing effects. There are two main impediments. One is that the adequate design of green taxes requires an amount of information which is simply not available. The other is that green taxes are usually administratively quite complex, but, as we have seen, the most dominant trend in tax reforms in developing countries is towards more administratively simple and less corruptible systems.

The country studies do not deal to any extent with green taxes. This does not suggest, however, that the authors think that they will not be important. It is a result of the difficult period that the countries have gone through, a time during which the subtleties necessary for any significant move in the direction of green taxation were overwhelmed by the macroeconomic considerations. Perry and Herrera note that Colombia is at the point where it is ready to pay more serious attention to the matter. This is also likely to be true in Mexico, if for no other reason than its obligations under the North American Free Trade Agreement.

One of the main messages of Pasco-Font's analysis is that a priori stabilization and structural reforms can have positive or negative environmental implications. It is very much a case by case and country by country situation. Similarly, Markandya and Richardson (1991) argue that in each country specific environmental regulations and/or taxes have to be put in place to minimize the negative effects of the large macroeconomic reforms. They also argue that the final environmental impact of many reforms will depend on land tenure and other institutional arrangements, considerations often neglected by developed country economists.

In the context of a lengthy review of command and control versus market-based instruments (including tradable permits), Pasco-Font places great emphasis on the administrative aspects of the final outcome. While most developed country economists are firmly in favour of market-based instruments, the administrative demands may be too onerous for many developing countries. Similarly, natural resource taxation may not be able to do better than rely on profit or output taxes.

The studies in this book suggest that fiscal federalism and environmental and sustainable development taxation have begun to increase in importance and are likely to continue to do so. The difficulty that both issues pose is that at a time when countries are almost uniformly trying to make their tax systems more simple, any significant attempts at decentralization or the introduction of green taxes is likely to complicate matters. While there are strong efficiency arguments for both decentralization and green taxation, these benefits could be overwhelmed by the losses from the administrative side. We have noted earlier that an attempt to reduce administrative costs has been one of the driving forces of fiscal reform in recent years.

V. Political Economy

From a political economy perspective, there have been three important forces behind the trends in fiscal reform of recent years. First, as Devarajan and Panagariya emphasize, the move from complicated quantitative restrictions and variegated tariffs to uniform, relatively low tariffs has been critical in reducing rent-seeking and saving resources. Second, the drive towards simplicity in tax systems has been partly for administrative reasons but the goal of horizontal equity has also played a crucial role. An important factor in government legitimacy is the perception of the public that individuals in the same income groups are being treated in a similar manner. Simplicity in rules by making evasion (in contrast to fraud) more difficult has greatly enhanced horizontal equity. In fact, Perry and Herrera, Rozenwurcel, Clarete and Diokno, and Choi and Roh in Colombia, Argentina, the Philippines, and South Korea, respectively, all argue that horizontal equity has been one of the most important goals of recent tax reforms. Third, in several successful cases it has been less difficult than previously believed to reduce employment and/or salaries in the public sector. Such cuts have been an important part of fiscal retrenchment in Argentina - at the central government level -, Mexico, and the Philippines as well as in the two successful mini-studies - Bolivia and Ghana - in the chapter by McMahon and Schmidt-Hebbel. Nevertheless, Enoh, Enoh and Koffi argue that this has been a major stumbling block in Cote d'Ivoire's reform process. As Rozenwurcel stresses in his chapter on Argentina, the failure of lower levels of government to adequately deal with this problem has been a major factor for the lack of adjustment in the provinces.

Fiscal reform has had less success in dealing with the problem of vertical equity. In general, income distribution effects across classes have been largely ignored in recent years. Urzúa gives data on Mexico which show that the share of the richest 10 per cent of the population rose from 33 per cent to 38 per cent during the period 1984 to 1989. Although Musgrave (1987) argues that it is facile to ignore distributional effects as all tax reforms have some, there does seem to be a general resignation that not much can be done on the matter, especially given the constraints imposed by globalization, (discussed further in the last section).[5] Nevertheless, there could be some scope for improvement, considering that at least in the case of middle-income developing countries there appears to be ample room to extend the share of the income tax in overall collection without increasing current tax rates. Unless this possibility is exploited, or the current wisdom of relying on the expenditure side of the equation proves beneficial for distributional balance - historically it has usually been more regressive than the revenue side -, it is likely that the issue of vertical equity will play an important political, if not economic, role in the future.

Finally, the biggest challenge for political economy and fiscal reform in the near future is likely to be fiscal federalism. Rozenwurcel and Sarma note the great difficulties in sharing the distribution of revenues and powers in Argentina and India, historically federal states. In countries which have traditionally been much more centralized, the decentralization of these powers is likely to be even more confused and difficult. The issue of tax harmonization across states or provinces is discussed at length in the chapter by Boadway, Roberts, and Shah. Of particular concern is the difficulty of avoiding beggar-thy-neighbour policies in which the competing regions try to undercut one another. Of course, this could lead to more efficient delivery of goods and services rather than just less of them.

In sum, the studies in this volume have shown that it is possible to overcome strong political economic forces. It may well be, however, that the relative success in recent years was directly due to depth of the various crises. Further progress is likely to be more difficult; once memories fade the danger of back-sliding is always inherent.

VI. Tax Administration

Tax administration has been a constant thread throughout this chapter, to the point where the reader would be justified to conclude that Casanegra (1990: 179) was correct to say: "Tax administration is tax policy." Nevertheless, while the experience of the last twenty years does suggest that better tax administration is a necessary condition for a successful reform, there are other factors driving tax policy in recent years separate from, although usually coloured by, administrative considerations. In essence, even if fraud and corruption were not significant problems, fiscal systems across countries would have some very different characteristics.

Historically, Tanzi argues in his thematic chapter, the most important determinant of tax structure for a country has been its economic structure. Different economic structures result in different tax handles, to which the tax system adapts.

As Devarajan and Panagariya and other authors in this volume argue, optimal tax theory has played a very minor role in the determinants of tax policy, almost always playing second fiddle to the interaction of economic structure and tax administration. In a regression across 63 countries using 1988 data, Tanzi is able to explain about 50 per cent of the variation in tax effort by only three variables - the share of agriculture, imports, and debt to GDP (the latter being a demand side factor).

The message coming out of the paper by Tanzi is that as societies have evolved and economies have changed through the centuries, different types of taxes have become feasible as the administrative costs associated with them have fallen significantly. For modern tax systems in developed countries, he argues that the three most important developments were modern accounting, the widespread use of money and increased literacy. Moreover, the movement from subsistence to exchange based economies was the driving force behind the first two. These changes allowed for the possibility of greater reliance on income and domestic sales taxes, for example, and less on land and foreign trade taxes.

At the same time, for any given economic structure and tax system it is obvious that tax yields can be very different depending on the administration.[6] Urzúa notes that a special audit unit set up in Mexico in 1989 had a rate of return of 4500 per cent! Rozenwurcel documents that a great administrative effort in Argentina resulted in a doubling of tax collection (measured in US dollars) from 1989 to 1992 while collection costs fell from 3.2 per cent to 2.7 per cent of total revenues. Enoh, Enoh and Koffi see very little way out for the Ivorian fiscal system other than an improvement in administration of the existing fiscal system. Nevertheless, Casanegra and Bird (1992:3) argue that a precondition for successful administrative reform is a simplification of the system.

It also seems likely that administrative issues will become more important rather than less so. In Section IV it was noted that the successful implementation of two of the most important emerging issues - fiscal federalism and environmental and sustainable development taxation - will be very much conditioned by administrative capabilities. In fact, it does not seem likely that much progress can be made on either of these issues until the tax administration rises to a new plateau.

In summary, the results of the various studies in this volume suggest that (as was probably intended in the first place) while it is an exaggeration to say that tax administration is tax policy, it is true that tax administration greatly constrains tax policy. On the other hand, initiatives to improve tax administration are themselves constrained by economic structure. It does not make much sense to put enormous efforts in improving the income tax system, for example, in a country which is dominated by agricultural and informal activities.

VII. Conclusions

The movement towards more simple tax systems which is common to all of the country studies can be interpreted as primarily due to administrative reasons and the adaptation (readaptation) of the tax systems to the economic structures of these countries. In the era of import substitution the incentive creating nature of tax systems more and more dominated the revenue generating functions. As we have seen, both indirect investment incentives, such as high import tariffs, and direct investment incentives, such as tax holidays, have been greatly reduced in developing countries. Even where the latter remain, Bird has emphasized that they should be very much adapted to administrative constraints. At the same time, as Perry and Herrera note, with the move to more open economies, it has been recognized that improperly designed fiscal systems can magnify the effects of domestic or external shocks. Therefore, the challenge is to build systems which are administratively feasible given the economic structure of the country, and which are also less susceptible to shocks.

We see at least three main lessons for fiscal reform in developing countries coming out of the various studies in this volume. First, long-run macroeconomic stability is not possible without fiscal balance. However, in the short-run it may be difficult to directly do much about the fiscal deficit unless the instability can at least be stopped temporarily. Quick-fix reforms (including privatization revenues) can then be combined with Olivera-Tanzi effects until a proper fiscal reform can be implemented. Special attention must be paid to the effects of changes in the real exchange rate on the fiscal balance.

Second, the convergence of fiscal systems in developing countries is not motivated by efficiency considerations in the sense of the public finance literature. Rather, it is the result of the interaction of at least three important forces. The most immediate of these was the widespread macroeconomic instability affecting many developing countries in the 1980s. It is interesting to note that the countries whose fiscal systems have least converged include the most successful countries, such as South Korea and Taiwan as described by Choi and Roh in this volume. Countries with large fiscal deficits were forced to rationalize their systems, but they found that this could only be done by first simplifying them. Thus, the second driving force was tax administration considerations, which demanded fewer and less complex taxes. The third and overarching force was globalization.

Globalization and trade liberalization have led to some tax harmonization across countries. Mexico, Colombia and Argentina, for example, have explicitly tried to harmonize parts of their tax systems with the United States. Much more important than tax harmonization, however, has been the pervasive move to more open economies. As noted above, the demise of the traditional import substitution strategy took away the theoretical underpinnings of much of the then existing fiscal systems.

The current conventional wisdom is that export oriented strategies demand only a neutral playing field and hence a very simple fiscal system, which is based on more efficient domestic based taxes and not on (inefficient) trade taxes. Of course, there still exists considerable amount of support for East Asian style interventions to promote export industries, especially in manufacturing. Many of the differences in tax systems today stem form this disagreement as to the role of incentives in an export oriented development strategy.

Our third, and much more tentative, lesson is that the convergence is only temporary. As economies settle down and countries become more confident, it is likely that the fiscal systems will take on new challenges. These may come in the form of meeting the emerging issues of fiscal federalism and green taxation. They may be in the development of non-traditional manners of stabilizing government revenues given the realization that short-run expenditure cuts are difficult to make. They could also stem from a belief that the lessons of the excesses of the import substitution era have been well-learnt and it is now possible to use incentives more judiciously and rationally.[7] It is also possible that income distribution may again become a focus of tax policy. Whether any of these changes take place in a given country will very much depend on its record with regards to stability, growth and the introduction of other structural reforms.

To conclude, we do not think that it is the "end of history" for fiscal systems, either from the revenue or expenditure side. In many ways and in many countries, the hard work has just begun.

ENDNOTES

1. While this price support system is called the Stabilization Fund, there is no fund per se as payments to or from the coffee and cocoa owners go into or out of general government revenues.

2. In fact, for the first time in nearly 50 years, the CFRA franc was devalued against the French franc in January 1994. The devaluation of 50% could have dramatic consequences for the fiscal situation. However, the analysis will be more difficult than usual due to the very large increase in coffee prices which also occurred in 1994.

3. Of course, there are those who argue that these incentives had little or nothing to do with the success of South Korea or Taiwan. The most famous proponent of this view is the World Bank (1993) analysis of the East Asian miracle. See Amsden (1994) and other critiques of the World Bank report in World Development, v. 22(4).

4. See Perry and Herrera (1994) for a more detailed discussion on this issue.

5. In fact, the Argentinean, Colombian and Ivorian country studies of the empirical effects of fiscal reform in this volume do include calculations of income distribution effects.

6. For general equilibrium analyses of tax reform which includes administrative costs of taxation, see the papers in this volume by Clarete and Diokno on the Philippines and Chisari on Argentina.

7. It should also be noted that the return to a greater use of incentives may very well hinge on the results of the debate over the importance of the new trade theory with its emphasis on returns to scale and endogenous growth.

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